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No. 76-975

In the Supreme Court of the United States

OCTOBER TERM, 1976

ARTHUR L. WINN AND SADIE N. WINN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

DANIEL M. FRIEDMAN,
Acting Solicitor General,
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The question presented in this federal income tax case is whether the decision below correctly held that petitioner's advances to his closely held corporation did not become worthless during 1966 or 1967, so that he was not entitled to bad debt deductions for those years.

The pertinent facts are as follows: In the early 1960's, petitioner[1] and his son decided to establish and operate a radio station in Rockland County, New York. They applied for a broadcast license, formed a corporation known as Rockland Radio Corporation, purchased and leased land, constructed a broadcast studio building, and leased a portion of the land and building to the corporation for

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[1] "Petitioner" refers to Arthur L. Winn. Sadie N. Winn is a party only because she filed joint returns with her husband for the years at issue.

broadcast facilities. The stock ownership of the corporation was as follows: petitioner—25 percent, his son—50 percent, and two Rockland County businessmen—25 percent. Apart from the $24,000 it received upon the issuance of its stock, the corporation borrowed the funds necessary to its operations. It borrowed $75,000 from a bank and received $51,000 in advances from petitioner through the close of 1965 (Pet. App. 2-8).

Rockland Radio commenced operations in September, 1965. It lost approximately $100,000 in 1965, and continued to lose money at the rate of $100,000 a year until operations ended toward the end of 1970. In order to sustain operations in 1966, petitioner advanced Rockland Radio an additional $100,000. Its 1966 balance sheet showed assets of $145,000 and liabilities of $370,000. Rockland Radio's liabilities thereafter increased by about $100,000 a year. In 1967, petitioner borrowed $10,000 from a friend and $74,000 from his son's mother-in-law, and he advanced those amounts to the corporation. In a last-ditch attempt to save the radio station in 1968, petitioner hired a new manager, changed the station's format, and advanced additional funds he obtained from borrowing. In July, 1968, petitioner rejected a $350,000 purchase offer for the station, believing that the radio station would turn profitable by September (Pet. App. 12, 14-19).

On his 1966 income tax return, petitioner claimed the $151,000 he advanced to Rockland Radio through 1966 as a bad debt deduction, and the unused part of that deduction as net operating loss carryback for 1963 and a loss carryover for 1967. On audit, the Commissioner of Internal Revenue disallowed the deduction on various grounds, including petitioner's failure to establish that the advances did not become worthless in 1966. In the Tax Court, petitioner asserted that, if the advances did

not become worthless in 1966, they became so in 1967. The Tax Court held that petitioner had not established that the advances became worthless in either 1966 or 1967 (Pet. App. 29-30). The court of appeals affirmed *per curiam* (Pet. App. 32-35).

Section 166(a) of the Internal Revenue Code (26 U.S.C.) permits a deduction for debts which become worthless within the tax year. As in the case of any loss deduction, the taxpayer must establish that the debt became worthless in the year for which he claims the deduction. *Wilson* v. *United States,* 376 F. 2d 280, 291 (Ct. Cl.). Debts may have two kinds of value. One is liquidation value, *i.e.,* the value derived from the excess of the debtor's assets over his liabilities. *Steadman* v. *Commissioner,* 50 T.C. 369, 376, affirmed, 424 F. 2d 1 (C.A. 6), certiorari denied, 400 U.S. 869.

The second type of value is potential value, which is measured by the reasonable expectation that the debtor, though perhaps currently insolvent, will eventually be able to repay his obligations. *Riss* v. *Commissioner,* 478 F. 2d 1160, 1166 (C.A. 8); *Steadman* v. *Commissioner, supra,* 43 T.C. at 376. The absence of potential value is most often established by an "identifiable event," such as bankruptcy, which eliminates the debtor's ability to make repayment. *Messer* v. *Commissioner,* 57 T.C. 848, 861; *Morton* v. *Commissioner,* 38 B.T.A. 1270, 1278, affirmed, 112 F. 2d 320 (C.A. 7). In other instances, the absence of potential value may be shown by so bleak an economic outlook that the possibility of recovery is as remote as it would be upon the occurrence of an identifiable event. *Steadman* v. *Commissioner, supra,* 43 T.C. at 377; *Morton* v. *Commissioner, supra,* 38 B.T.A. at 1278.

Here, the Tax Court found that petitioner's advances to Rockland Radio Corporation had both liquidation and

potential value in 1966 and 1967 (Pet. App. 23-27). In support of this finding, the court pointed to the absence of an identifiable event in 1966 or 1967 that made repayment impossible (Pet. App. 23, 27) and the facts that Rockland Radio continued its operations into 1970, that petitioner made sizeable advances to the corporation in 1967 and 1968, that petitioner rejected a $350,000 offer for the sale of the station in 1968, and that in 1968 petitioner represented to lender banks that he expected the station to become profitable in the near future (Pet. App. 24, 26, 29).

Petitioner contends (Pet. 7-11) that the decision below improperly relied upon his subjective hopes for recovery of the advances. In his view, a determination of value cannot be based on the taxpayer's hopes but must rest on objective facts supporting a reasonable prospect for recovery. But the decision below does not turn on petitioner's subjective thoughts but on his objective actions.

The actions of the parties may be taken into account in appraising the economic condition of a debtor and the value of claims against him. Thus, for example, the courts have frequently found a lender's extension of additional credit or forbearance in requiring repayment to be highly persuasive as to the existence of potential value. See, *e.g., Riss* v. *Commissioner,* 56 T.C. 388, 408, affirmed, 478 F. 2d 1160 (C.A. 8); *Trinco Industries, Inc.* v. *Commissioner,* 22 T.C. 959, 965. Here, petitioner provided additional credit to Rockland Radio in order to continue its operations into 1970. Moreover, in 1968, he rejected a substantial offer to purchase the station. Under these circumstances, the decision below correctly held that petitioner had a reasonable expectation of repayment

in both 1966 and 1967. He therefore was not entitled to a bad debt deduction for either of those years.[2]

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DANIEL M. FRIEDMAN,
Acting Solicitor General.

MARCH 1977.

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[2]The cases petitioner cites (Pet. 8-10) do not conflict with the decision below. Unlike the situation here, an identifiable event terminating the debtor's future business prospects had occurred in those cases, and the creditor or investor had made no further advances.